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Memorandum for:

Attached is background material for next May's Tokyo Economic Summit. It was requested by Mr. Steven Danzansky, Senior Director for International Economic Affairs, NSC, and was delivered to him on 14 November 1985 in preparation for 21-23 November 1985 Sherpa meeting.

EUR M 85-10187



14 November 1985

E U R A

**Office of European Analysis
Directorate of Intelligence**

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JapanPolitical and Economic Setting

The Tokyo Economic Summit comes at a crucial time in Prime Minister Nakasone's political career and US-Japan economic relations. Nakasone's second two-year term as Liberal Democratic Party (LDP) President and Prime Minister ends next fall, and succession maneuvering will be near its peak within the ruling party by next spring. Nakasone undoubtedly views a successful Summit—including the help it would give the LDP in the national Diet election scheduled for June—as a boost to his chances of changing party rules and extending his term beyond October 1986. [redacted]

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A reputation for leadership in foreign affairs is fundamental to Nakasone's standing in the LDP and has helped his administration maintain an unprecedented level of public support. In the past, the urge to demonstrate leadership has prompted the Prime Minister to make commitments without first clearing them with party leaders and the bureaucracy. However, both his role as host and the domestic political situation may make Nakasone more cautious, leading him to seek compromises to ensure a smooth, if undramatic, Summit. [redacted]

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Any pressure Nakasone feels to offer or support economic policy initiatives at the Summit will almost certainly come from external rather than internal sources. Top government and party officials regard overall Japanese economic performance as satisfactory and see little domestic reason to adjust their fiscally conservative economic policies. Economic growth for 1985—although likely to slow at yearend—will approach 5 percent, the unemployment rate is a politically acceptable 2.6 percent, and consumer price inflation is only 2.5 percent. The only significant worries are possible trade restrictions imposed by its Summit partners as Japan's current account surplus approaches \$43 billion this year and a possible slowdown or drop in burgeoning exports to China. [redacted]

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Issues of Interest

Despite Nakasone's promise to President Mitterrand to keep the Summit informal, the Japanese are already drawing up detailed position papers for possible agenda items. We do not expect the agenda to differ much from previous Summits. [redacted]

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Nakasone would prefer talking about global political developments but, in our view, realizes Summit discussions will focus on cooperation in solving trade problems. For example, Nakasone may push to continue the joint currency intervention begun in September and propose that Summit partners more closely coordinate their fiscal and monetary policies to ease the trade imbalance. The recommendations of a high level committee studying medium-term measures to reduce Japan's trade surplus are due in March, in time to be presented at the Summit. Nakasone will probably try to limit country-by-country discussion of

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trade problems; if pressed he almost certainly will point to recent Japanese studies showing its markets almost as open as the United States and far more so than those of most European countries. [REDACTED]

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Macroeconomic Policy Coordination

Nakasone may call for coordinated adjustment in macroeconomic policies, in keeping with the Japanese view that US budget deficits and their expansionary impact are the root cause of Tokyo's trade imbalance with the United States. In theory, countries with large trade deficits would slow their economies to discourage imports, while countries with surpluses--Japan and West Germany--would stimulate their economies to boost imports. For the Japanese, however, this essentially represents a call for reducing the US budget deficit and interest rates and should not be a rationale for Tokyo to play a role, like its mission in the late 1970s, as a "locomotive" for the world economy. Many government and party leaders believe Tokyo's large budget deficit and national debt resulted directly from this misguided--in their view--attempt at economic stimulus. [REDACTED]

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International Monetary Reform

The apparent success of the recent joint currency intervention may induce Nakasone to discuss alternatives to the current floating exchange rate system. In doing so, he could hope to demonstrate that Tokyo is willing to continue its efforts to ease trade frictions. It is not yet clear whether the Prime Minister will table a specific proposal, but we believe Nakasone may feel the time is right to revive the French proposal of target zones for major currencies. Japanese business leaders from the Keidanren (Federation of Economic Organizations) recently expressed interest in the proposal during a visit to France. [REDACTED]

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International Trade

[REDACTED]

[REDACTED] Tokyo supports negotiations on services, but we believe Nakasone may propose a compromise on the issue to encourage the participation of key LDCs. In a recent press conference at the UN, he referred to Japan's role as "a bridge between North and South." The new round, and the upcoming Summit, could provide Nakasone with opportunities to play this role. To date, Tokyo's diplomatic efforts on behalf of a new round have been aimed primarily at the LDCs, and the US Embassy in Tokyo indicates Japanese officials want to maximize LDC participation in the new round. [REDACTED]

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Third World Debt

The Japanese have been cautiously optimistic so far about the US proposal to increase the World Bank's role in managing the international debt

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problem. [REDACTED]

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High Technology

We believe Tokyo is unlikely to initiate discussions on technological exchange with Summit partners. If technological issues come up, Tokyo is likely to stress its encouragement of private technical exchanges and Japanese investment in European and US high technology industries. [REDACTED]

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[REDACTED] Japan's involvement in EUREKA -- and perhaps SDI -- could be limited by Japanese law, which prohibits the development of space equipment for military purposes. We believe Japan will participate actively in the US space station due to the interest of Japanese industry in cooperative aerospace development. [REDACTED]

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International Terrorism

The Japanese Government is showing increased interest in international cooperation to fight terrorism and will likely place the issue on the Tokyo Summit's agenda. At a recent meeting with Summit Seven Foreign Ministers, Foreign Minister Abe responded favorably to the proposal calling for revitalization of the Bonn Statement on Air Hijacking. If a dramatic event or incident precedes the May Summit, Nakasone might push for an even stronger statement condemning international terrorism. He probably would refrain from seeking a consensus on sanctions, however, because past proposals have been vehemently opposed by several Summit countries. [REDACTED]

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West GermanyPolitical and Economic Setting

West German Chancellor Helmut Kohl needs a strong showing at the Summit to help overcome his government's declining popularity and his image of indecisiveness and inaction. His position has been damaged recently by setbacks for his party in state elections, a string of spy scandals, and continuing divisions over economic and foreign policy. At Tokyo, the Chancellor will be thinking about the next federal election in January 1987. Although the current coalition is likely to be returned to power in 1987 and no logical successor is presently in the wings, Kohl's position as leader is by no means guaranteed. [REDACTED]

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Kohl is preoccupied with the domestic economy, and in some areas he can point to successes. The economy is growing at a respectable, albeit slow, rate of 2.5 percent, inflation is down, and the trade and current account surpluses are at record levels. Nonetheless, unemployment remains stubbornly high at around 9 percent, and Kohl has yet to enact the wide-sweeping, market-freeing reforms promised when he entered office. On the monetary front, the Bundesbank cut the discount rate last August to promote economic growth, [REDACTED]

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Issues of InterestMacroeconomic Policy

Kohl will resist arguments by other Summit members at Tokyo that West Germany and Japan need to reorient their domestic economic policies to promote world growth. If pressed, Kohl may recall the "locomotive theory" of past summits. He will cite West Germany's low inflation and interest rates, its free trade policies, and successful budget-balancing programs as his nation's contributions to global economic stability. Bonn does not believe it made any commitment to stimulative fiscal policies at the September G-5 meeting in New York. Kohl will urge the US to intensify its own deficit-reduction efforts. [REDACTED]

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International Monetary Reform

Kohl is likely to support calls for continued joint currency intervention and closer exchange rate surveillance by the IMF. [REDACTED]

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[redacted]

[redacted] Bonn is generally pleased with the new readiness of the US to intervene against the dollar, but is skeptical about whether such actions can have a lasting impact on currency values. The Finance Ministry remains convinced that the US budget deficit must first be tackled before Washington can lower the real interest rates that Bonn argues are propping up the dollar. [redacted]

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Trade Issues

Kohl considers renewed commitments to free trade as the most important result of earlier summits and will push Tokyo participants to again pledge to resist protectionism. West German officials at all levels have expressed anxiety over growing protectionist sentiment in the US, and Kohl will urge the President to veto protectionist legislation coming out of the US Congress. Bonn will again declare its support for an early start to a new GATT round. [redacted]

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West Germany is less concerned about trade problems with Japan than other EC members, and is likely to block attempts by France or Italy to gang up on the Japanese. Bonn, however, would endorse a resolution urging Tokyo to expedite efforts to open up its domestic markets. [redacted]

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Third World Debt

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[redacted]

Kohl's stance at the Summit will depend on the success of interim US efforts to line up commercial bank support and to induce more constructive attitudes on the part of debtor governments. [redacted]

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High Technology

West Germany, like other EC countries, perceives a widening technology gap vis-a-vis Japan and the US, and has responded with increased funding for R&D. Bonn would also like to channel more funds to industrial, rather

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[redacted]

than basic, research. Kohl intends to contribute to EUREKA, but wishes the program to be funded and directed chiefly by the participating firms. Despite misgivings by Foreign Minister Genscher, Kohl continues to back a bilateral agreement covering West German participation in SDI. West German firms are eager for such an agreement to ensure their access to SDI technologies. [redacted]

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International Terrorism

Since the 1972 Munich Olympics tragedy, Bonn has expanded its anti-terrorist apparatus. The police have dealt setbacks to the terrorist networks, but the threat of attacks on domestic and NATO targets remains real, as evidenced by the recent spate of bombings by the Red Army Faction. Kohl would certainly agree to expanded international cooperation against terrorism, but would be leery of imposing economic sanctions against states that sponsor terrorists. Kohl would not agree to committing West German troops to anti-terrorist operations outside his borders, but might discreetly agree to diplomatically back such operations by the US and to permit the use of bases in West Germany as staging areas. [redacted]

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FrancePolitical and Economic Setting

France's behavior at Tokyo will be shaped by the results of the 16 March National Assembly election. President Mitterrand's term runs until 1988, but current polls indicate that after the March election he is likely to face an Assembly controlled by the conservative opposition. Technically, the French President is the head of state, while the Prime Minister, who represents the majority or ruling coalition in the National Assembly and is appointed by the President, is the head of government. This distinction has had little practical significance in the Fifth Republic, which was designed in 1958 to enhance executive power. Until now, all presidents have enjoyed a majority in the National Assembly, and have, with the cabinet's assent, assumed the responsibility for foreign economic affairs and spoken authoritatively for France at the Economic Summits. This power, however, is not clearly mandated by the constitution. With the probable advent of what the French have come to call "cohabitation," France is likely to enter a period of political and constitutional confusion that may make it difficult for Paris to follow a consistent and forceful policy. [redacted]

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Assuming the opposition does win the election, we see four possibilities for French representation:

-- The most likely is that Mitterrand will attend, as in years past. Mitterrand's authority, however, would be uncertain, and therefore he probably would not introduce or agree to any significant new initiatives. As a result, he would be less likely to play the spoiler, as he did at Bonn. Mitterrand almost certainly would have domestic politics uppermost in his mind, and probably would try to demonstrate his statesmanlike qualities and ability to rise above the domestic political fray. By the same token, he would be especially tough in defending French interests as he played to his domestic audience.

-- France could be represented by the new Prime Minister. The main contenders appear to be Jacques Chirac, the Mayor of Paris, and former President Valéry Giscard d'Estaing. The new Prime Minister would have a real fight on his hands to replace Mitterrand--who has made clear his determination to continue calling foreign policy shots whatever the election outcome--and probably would not have time to win such a battle before the Summit. While the Prime Minister also could be expected to take a nationalistic line, he might try to distance himself from the previous Socialist government by stressing that he is in closer step with other Summit governments.

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[redacted]

-- France could be represented by both the President and the Prime Minister. We do not consider this likely, as it would draw embarrassing attention to France's domestic political squabbling. In such a case, we would expect French policy to be confused and contradictory, with the two French representatives often trying to upstage each other.

-- France could be represented by a lower level official agreeable to both the President and the Prime Minister, possibly the Foreign Minister. This is the least likely possibility because Paris clearly would prefer not sending someone who obviously would lack the clout to be taken seriously--unless the President and Prime Minister were united in wanting to send a strong signal of France's disapproval of the way the Summits have evolved. [redacted]

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On the economic side, France is dogged by over 10-percent unemployment and sluggish economic growth. The austerity program implemented by the Socialists in 1983, however, is beginning to bear fruit. France's inflation rate continues to drop and is likely to be near 5 percent this year. More importantly, the inflation differential between France and its major trading partners has narrowed to near 2 percentage points. In addition, unemployment has been stable since the first quarter of this year and dropped significantly in September. The current account was nearly balanced last year after a \$5 billion deficit in 1983, and we expect a \$1 billion surplus this year. Both the government and the opposition recognize their need to run a current account surplus for debt service needs and will depend on foreign growth for any stimulus to the economy. Growth for both this year and next year is expected to be near 2 percent.

[redacted]

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Issues of Interest

Macroeconomic Policy

France is unlikely to approach the Tokyo Summit with a long macroeconomic policy agenda. In our view, French macroeconomic policy will in most important respects remain consistent over the next year, regardless of who wins the March election. In particular, the austerity program adopted by Mitterrand is not likely to be abandoned. The conservatives may introduce harsher measures to cut the budget deficit, and overall will probably pursue a program of liberalizing the domestic economy and denationalizing some of France's largest companies. France's domestic economic restructuring efforts are likely to continue to focus on improving competitiveness, rationalizing French industry, and encouraging domestic investment. [redacted]

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International Monetary Reform

Paris attaches great importance to stable currency values and has persistently argued for joint intervention in foreign exchange markets. French officials were especially pleased with the September G-5 agreement to try to weaken the dollar. At Tokyo, France is likely to argue for further progress along these lines, and perhaps for a formalization of intervention arrangements. The French representative will probably also reiterate France's contention that talks on international monetary reform should accompany the new GATT round. [REDACTED]

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Trade Issues

France is publicly committed, in principle, to a new trade round, and Paris voted in favor of a US proposal for an extraordinary meeting of the 90 contracting parties of the GATT to begin preparing for trade talks next year. [REDACTED]

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[REDACTED] French officials have told US diplomats that they still have misgivings about some of the areas to be discussed, especially agriculture and high technology. The French are also likely to continue encouraging influential developing countries to employ dilatory tactics. [REDACTED]

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[REDACTED] The French representative at Tokyo is likely to be especially blunt in condemning any US trade actions that are irritating the EC. French officials have recently reacted strongly, for example, to the US decision to initiate GATT proceedings against EC wheat export subsidies. One French trade official warned a US Embassy officer that Paris considers the move "destructive" to the new trade round. [REDACTED]

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France will be in the forefront of EC countries pressuring Japan to increase imports. Press reports indicate that French officials take a wary--if not cynical--view of recent Japanese promises to open markets. During Nakasone's July visit to France, Cresson described Japan as a country that is "protectionist in both its habits and its regulations." France probably intends to single Japan out for its unfair trading

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practices during the new GATT round as well; in a September meeting with US trade officials, French representatives said that the multilateral talks must be used as a means to open the Japanese market. [redacted]

Third World Debt

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French officials have reacted favorably to the proposals Secretary Baker made at the Seoul meeting of the IMF and IBRD. In general, however, French activities on the debt issue have been long on rhetoric and short on substance. The Mitterrand government has frequently complained that the developed countries' approach to global debt does not take sufficiently into account the political consequences for Third World governments of economic austerity. Paris has stopped short, however, of openly advocating an international debtors conference to forge a global debt policy. During a visit to Brazil last month, Mitterrand suggested France might be willing to reschedule some of Brasilia's \$9 billion in bilateral debt, but French spokesmen later insisted this was merely a statement of possibilities to be explored, not French policy. At Tokyo, France is likely to continue stressing that the special needs of developing countries should be met, but France is unlikely to advance any specific proposals. [redacted]

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High Technology

France was surprised last spring with the US push for SDI, and Paris responded by hurriedly cobbling together its own proposal for a European civilian high technology initiative, EUREKA. Although West European -- including French -- interest in SDI has steadily grown, EUREKA is still mired in its formative stages, and its chances for success are diminishing as the proposal languishes. Paris has rejected official French approval of SDI as a strategic principle, but has encouraged French firms to participate on a company-to-company basis. [redacted]

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[redacted] French firms have, with the blessing of Paris, been among the most aggressive in pursuing SDI contracts. Should the issue of SDI arise at Tokyo, France is likely to continue its policy of official refusal to sanction SDI. Some conservative politicians have indicated they might review this policy, however, and in a late-October debate Chirac suggested strongly that there might be an SDI role for France in medium-range missile defense. French representatives are, in any case, likely to continue championing EUREKA, stressing the need for Europe to develop its indigenous technological capabilities. [redacted]

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International Terrorism

Paris is acutely aware of the international terrorist threat; according to CIA statistics, in 1984 French interests were the number one terrorist target worldwide. Despite this dubious distinction, Paris generally opposes multilateral approaches to terrorism, considering them to be

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ineffective. Similarly, France believes that the statements on terrorism issued at previous Summits were empty and raised false hopes that the major western countries can, by acting in concert, control the problem. The French representative at Tokyo is therefore likely to resist any declarations that generally condemn terrorism and promise multilateral cooperation. Paris probably will argue instead that terrorist threats should be dealt with on a case-by-case basis by the countries involved.

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Reforming the Summit Process

Paris has argued in recent years that the summit process needs to be overhauled, and after last year's Summit Mitterrand threatened to boycott future meetings. Mitterrand found the Bonn Summit--where he was generally isolated, even from his EC partners--particularly distasteful. He has complained that the summits are too sterile, structured, and overly orchestrated, and do not permit the informal exchanges of views France envisioned when it hosted the first summit at Rambouillet in 1975. During Japanese Prime Minister Nakasone's visit to Paris in July, Mitterrand likened the summits to a "boxing ring" where "beforehand, it is announced that seven friendly countries are going to fight. It's a bad method," Mitterrand declared, "and if this method doesn't change, I don't see the interest of France participating in such things."

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Mitterrand's threat to boycott future summits probably should not be taken idly. We believe, however, that concern for French prestige and determination to be counted among the world's economic powers will force Paris to attend the Tokyo meeting, however much the French grouse about the summit process. According to press reports, Nakasone left his July meetings with Mitterrand confident that France would be present at Tokyo. Nevertheless, the French may make summit reform one of their priorities at Tokyo. They are likely to argue for a more streamlined system capable of producing tangible results.

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United KingdomPolitical and Economic Setting

Despite sharpened attacks against her economic policies and accusations of "insensitivity" to the poor and underprivileged, Prime Minister Thatcher appears to be as self-assured as ever. She remains committed to reforming the British economy and changing long-held social attitudes. Thatcher weathered a rough period during the spring and summer when the Tories suffered embarrassing losses in a number of local elections and her party's ratings fell to third place in national opinion polls. More recently, however, the Tories have regained a slight lead over both the Labor Party and the Social-Democratic/Liberal Alliance. Without making any major shifts in policies, Thatcher has begun to try to improve the government's image in time for the next general election, which must be held by June 1988. She appears, for example, to be rethinking some controversial proposals for cutting back social welfare, and has taken at least cosmetic steps to alleviate the 13-percent unemployment rate. [REDACTED]

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Britain was the first of the summit countries to pull out of the recession of the early 1980s, and most forecasters predict real GNP growth of 3.5 to 4.0 percent this year and 2 to 3 percent in 1986. Private investment, consumer spending, and export earnings are all rising at a healthy pace despite consistent complaints from business leaders that interest rates are too high and will eventually choke off growth. Exports and investment are likely to slacken during 1986, as sterling appreciates against the dollar and tax incentives for investors expire. Nevertheless, consumers' expenditure should continue to fuel expansion, especially if inflation remains in the 5 to 6 percent range and the government goes through with promised tax cuts in the 1986/87 budget. [REDACTED]

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Unemployment remains the most serious problem facing the Thatcher government. Violent outbreaks in London and other urban areas in recent weeks focused worldwide media attention on the problem of working-class youth who have little prospect of employment. British officials have become increasingly defensive about their policies, which place primary emphasis on the role of the private sector in creating new jobs. In order to combat joblessness without additional government spending, Thatcher's recently appointed Employment Secretary, Lord Young, has stepped up efforts to reduce regulations on small businesses and promote programs to encourage entrepreneurs. In addition, the Defense Ministry is planning to transfer some facilities to areas of high unemployment in northern England. Despite these palliatives, the unemployment rate is staying high because of a bulge in the number of working-age individuals and the increased number of women who are seeking part-time work. Most forecasters do not expect any improvement in the situation over the next few years. [REDACTED]

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Issues of Interest

Macroeconomic Policy

The British believe that it is essential for the industrial countries to better coordinate their fiscal and monetary policies to stabilize the world economy. To this end, Thatcher will undoubtedly pressure the United States to take effective action to combat its budget deficit. She probably would go along with the United States in encouraging reflation in the West German and Japanese economies, but would resist suggestions that she reflate the British economy. British officials frequently defend their policies by pointing out that the British economy is currently growing at a faster rate than any of its European allies. Moreover, they firmly believe that increased government spending would not alleviate the domestic unemployment crisis. [REDACTED]

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International Monetary Reform

Thatcher does not believe that exchange rate intervention can alter underlying market trends over the long run, but she is likely to push for coordinated intervention efforts as a short-term measure. In this regard, London supports the recent G-5 decision to lower the value of the dollar through central bank intervention. London believes the G-5 accord also shows that Washington recognizes better coordination of fiscal and monetary policies is necessary among the industrial countries to smooth out exchange rate fluctuations. [REDACTED]

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British officials are reluctant to say publicly how far they want the dollar to fall relative to the pound or any other major currency, arguing that the true value of the dollar must be determined by market forces. In common with all the Summit participants, Thatcher is hoping for a "soft landing" of the dollar because she has reason to be wary of a sharp or swift depreciation. The British economy stands to benefit from reduced inflationary pressures and lower defense costs as the price of dollar-denominated imports declines. Thatcher would also welcome a stronger pound as a vote of confidence in both her leadership and economic policies. The economic benefits of lower inflation, however, would likely be offset by slower growth, as British exports became less competitive with US products on world markets. British officials are also concerned that a sharp decline in the dollar would cause Washington to adopt a restrictive monetary policy to avoid a surge of inflation in the United States. They are concerned tight monetary policy would lead to a slowdown in US economic growth which would impact negatively on the world economy. [REDACTED]

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Trade Issues

Among Thatcher's foremost concerns at Tokyo will be combatting protectionist sentiment in the US Congress. British officials share Washington's assessment that a trade war would have tragic consequences. London generally supports US efforts to liberalize trade, and in particular wants to begin a new GATT round as quickly as possible. Britain wants as broad a coverage of services as possible and is prepared to leave open the question of whether to seek universal rules or agreement among a sub-group of GATT countries. London also favors, in principle, including new issues such as "intellectual property" or investment in negotiations, but fears that overly ambitious proposals could scare moderate LDCs into opposing all new initiatives. [REDACTED]

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On other trade issues, London supports joint US-EC pressure on Japan to correct the trade imbalance. Secretary of State for Trade and Industry Leon Brittan recently said that it would be reasonable for the EC to ask Japan for a quantitative estimate of the impact of moves it was making to increase imports. Thatcher hopes that the issue of trade sanctions against South Africa will not be raised at the Summit. If it does come up, she will maintain the UK's opposition to new mandatory sanctions and will count on the United States and West Germany to support her position. Lastly, London probably would not want the United States to raise Britain's controversial policy that favors British-based firms in granting contracts for energy-related technology, preferring to resolve this problem on a bilateral level. [REDACTED]

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Third World Debt

London is now expressing more concern about the international debt problem than it has in the past. The British welcomed Secretary Baker's recent proposals for an increased role for the World Bank and greater commercial bank lending to LDCs. For historical reasons, the United Kingdom is especially concerned about the situation in the poorest African nations and was pleased that Washington explicitly recognized the existence of various categories of debtor countries, rather than concentrating solely on Latin America. British officials stress, however, that they cannot predict whether UK bankers will be willing to increase loans to LDCs, and the government is not likely to put pressure on domestic bankers to do so. The British Cabinet is currently split over future aid disbursements, with Foreign Secretary Geoffrey Howe battling with the Treasury for additional budget allocations. [REDACTED]

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High Technology

London is concerned about the growing technology gap between Europe and the United States and Japan. The Thatcher government has vigorously pushed the development of high-tech industries to improve British competitiveness. London has increased funding for innovative projects and has also pushed for better coordination of West European high technology efforts. The British support the EUREKA project, but they do not want it to take an anti-US or anti-SDI tone. The government has said it will provide grants to British firms participating in the project but the funds will come out of existing programs. Recent statements, however, indicate that London is beginning to believe more government support is needed for the project. []

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International Terrorism

Prime Minister Thatcher remains extremely interested in forging worldwide cooperation against international terrorism. London fully supports Washington's actions on the anti-terrorism front, including the recent interception of the Achille Lauro hijackers, and is anxious to work as closely as possible with the US government on all aspects of the problem. The British are jointly working on a ten-point plan with friendly countries, which seeks, among other things, to ensure that diplomatic immunities are not abused by states that support or condone terrorism and to secure agreement that no concessions should be made to terrorists' demands. Thatcher is also actively trying to curtail the role of the media in reporting--and she believes encouraging--terrorist activity. She recently proposed that the international media draw up a voluntary code of conduct to reduce the publicity given to hijackers and terrorists. []

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ItalyPolitical and Economic Setting

The collapse of the government over its handling of the Achille Lauro hijacking has created a great deal of uncertainty in the Italian political scene -- even though members of the five-party coalition have agreed to reform the same government under the leadership of Socialist Bettino Craxi. The crisis highlighted differences among the five parties over the government's Middle East policies, and also brought to the surface a number of other disagreements, especially on economic issues. These fissures have been only papered over. The revived coalition is likely to be less stable than it was before the crisis, raising the possibility of early elections -- after the Christian Democratic, Communist, and Socialist party conferences next April. [redacted]

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Differences over economic policy will almost certainly come to the fore when the government tackles the 1986 budget -- and it seems safe to say that the bill will not pass before the 31 December deadline. In an attempt to contain the massive public sector deficit -- now over 15 percent of GDP -- the Cabinet's proposal contains controversial cuts in spending on health, transportation, and pensions, as well as increases in indirect taxes. The Communist Party, the labor unions, and even many Cabinet ministers strongly oppose expenditure cuts while others, led by the Republican Party, staunchly oppose new taxes and demand even deeper cuts in spending. This divisiveness is likely to result in a lengthy parliamentary debate and a weakened final package that will not keep the deficit from rising next year. [redacted]

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While the budget deficit is Rome's top economic priority, it is also concerned about sluggish growth, continuing inflation, and a deteriorating trade balance. Real GDP growth probably will drop below 2 percent in 1986, down from 2.3 percent this year, as investment slows. Sluggish growth will exacerbate Italy's unemployment problems as expansion of the service sector fails to offset declines in industrial and agricultural employment. Italy's inflation rate -- 8.6 percent for the twelve months ending in September -- remains much higher than rates in the other Summit countries. Moreover, no improvement is likely next year because the huge budget deficit probably will lead to a more accommodating monetary policy. Continued high inflation has eroded Italian competitiveness and contributed to a worsening of the current account, -- from a small surplus in 1983 to a projected \$6.6 billion deficit this year. The 8-percent devaluation of the lira in July should reverse this trend and result in a small improvement in the trade and current account deficits in 1986. [redacted]

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Issues of Interest.

Preoccupation with reinstating the government has undoubtedly prevented the Italians from giving much thought to November's preparatory meeting for the Tokyo Summit. Uncertainties over the future of the five-party coalition and the possibility of early national elections shortly after the Summit make it particularly difficult to judge what specific positions Rome will take in Tokyo. The Italians usually let the French or West Germans take the lead, but, if elections are called, the Prime Minister will be more assertive than usual in an effort to boost his image at home. [REDACTED]

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Macroeconomic Policy

At past Summits the Italians have pushed for greater coordination of macroeconomic policies, but the issue is likely to make Craxi uncomfortable in Tokyo. The Italians are eager for the other West European countries, particularly West Germany, to reflate in the hope that it will aid Italian exports. Craxi cannot push this line, however, without raising criticism of Italy's massive budget deficit. Italy is already under pressure within the EMS to bring spending under control to avoid any further devaluations of the lira. For the same reason, Craxi will be restrained in his demands that the US cut its deficit. [REDACTED]

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International Monetary Reform

Although Craxi earlier considered supporting the idea of an international forum on monetary reform in conjunction with a new GATT round, he has not made it a precondition to the trade discussions. On exchange rates, Italy is more concerned with the lira's performance within the EMS than with its movements against the dollar. Nonetheless, the Italian Government protested its exclusion from the recent G-5 meeting, claiming that it imposed a burden on Italy -- to maintain its EMS commitments -- which warranted Italy's inclusion in the discussions. Craxi probably will press for the extension of exchange rate surveillance to the G-10 or at the least to the Summit Seven. [REDACTED]

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Trade Issues

Italy's worsening foreign deficit will put trade issues in the forefront of Italian concerns in Tokyo. The Bonn Summit did not allay Italian fears of rising barriers to trade, and Craxi is likely to strongly condemn protectionism, focusing his criticism on Japan and the United States. Nonetheless, Italy gives only lukewarm support to a new GATT round. Its enthusiasm for a new round is tempered by the belief that further talks will push aside more important efforts to strengthen existing regulations. Craxi will insist that the scope and timing of trade talks be

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clearly defined. He fears that a new trade round could do more harm than good if it launches grand initiatives that then founder and undermine the credibility of the industrial nations in the eyes of the Third World. The Italians probably will press for the GATT round to address trade in high technology, agriculture, and services, although they believe US demands on the latter topic must be held in check to avoid raising the hackles of the LDCs. [REDACTED]

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Third World Debt

Italy is again likely to champion Third World rights at the Summit. Craxi was disappointed at the light treatment the problem of LDC debt received in Bonn and is concerned that failure to confront the issue will diminish the credibility of the industrial nations. Italy has expressed cautious optimism over the US proposal for an IMF/IBRD special facility. The Italians have consistently supported measures at the Summits to increase the resources available to LDCs -- including a capital increase for the World Bank and a re-examination of financial support for IDA. Craxi will again press for closer collaboration between the IMF and the World Bank, and also for closer coordination of bilateral assistance. Italy also believes that the World Bank should use its lending only for adjustment purposes and not for projects. [REDACTED]

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High Technology

Craxi will be interested in discussing methods to promote high technology. Craxi believes the easiest way for Italian companies to obtain technology is through joint ventures with foreign firms and, therefore, is enthusiastic about Italian participation in EUREKA. Italy, however, objects to several points of the present proposal, particularly regarding structural organization and funding. Fearing that less competitive Italian firms will be squeezed out of EUREKA projects, Italy has demanded a more active governmental role in the decisionmaking process and wants a permanent oversight committee to ensure equal participation for smaller countries and companies. Italy also fears the initiative will collapse if the projects must rely on private funding without government aid. Italy has actively solicited the support of the smaller European countries for its position. [REDACTED]

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International Terrorism

This could be a topic of keen interest to the Italian government in Tokyo, especially if Craxi still feels the need to defend his handling of the Achille Lauro hijacking. Craxi will insist that Italy took appropriate measures to punish the terrorists. Although he is not likely to propose specific new anti-terrorist measures, he probably will push for a unified multilateral strategy to cope with international terrorism. The Italians

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[redacted]
oppose economic sanctions against states supporting terrorism, however,
arguing that too many other countries would be willing to fill in the gaps.
[redacted]

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Reforming the Summit Process

Craxi sympathizes with French complaints that the summit process has become too bureaucratic and would probably endorse a call for smaller meetings limited largely to the heads of state. Rome has also complained about the increased tendency for political issues to push economic discussions to the backburner, and Craxi may call on his summit partners to limit their talks to economic problems. [redacted]

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CanadaPolitical and Economic Setting

Prime Minister Mulroney's Conservative government is currently preoccupied with reversing its decline in the polls -- from a 47-percent approval rating in June to 40 percent in October -- and resolving a potential crisis in the country's banking industry. Since Parliament reconvened in September, the government has been shaken by the resignation of two important Cabinet ministers in scandal-related circumstances. More ominous has been the collapse of two Canadian banks -- the first such failures in 62 years. In addition, Mulroney's personal integrity is being questioned because of his reputed prior knowledge of the recent scandals and failure to deal with them before they became public. According to the US Embassy in Ottawa, the Tories are suffering from shellshock after their "Black September" and are looking for a breathing space in which to regroup. Mulroney may even end the current parliamentary session in mid-December -- six months ahead of schedule -- in an effort to get a fresh start in the new year; this would almost certainly be seen as a sign that the government is on the defensive.

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The Canadian economy is growing this year at a 4-percent rate, down from 5 percent in 1984. Although the 1985 budget only managed to slow the growth of Canada's budget deficit -- currently projected to be \$27 billion, or about 7.5 percent of GNP -- it did stimulate higher employment by delaying tax hikes until 1986. Investment spending has been strong because of low interest rates and a new federal energy policy which substantially reduces taxes in the energy sector. Meanwhile, the relatively weak Canadian dollar -- the only major currency to have depreciated against the US dollar since the beginning of 1985 -- will enable Canada to post an estimated \$15 billion trade surplus this year.

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Issues of InterestMacroeconomic Policy

Ottawa believes that US economic policy is out of sync with other Summit countries, but it will not focus on this issue because of its own large budget deficit. The Tories are currently preparing for their second budget, now expected in January or February. The party pledged to cut the deficit in its election campaign and did so marginally in its initial budget last May. Since then, however, Ottawa has been forced to make several large and unexpected expenditures -- most notably \$730 million to shore up the banking system -- which will erase a major portion of the projected deficit reductions. Ottawa is unlikely to be able to cut the

[redacted]

deficit substantially in its next budget, mainly because the Tories lack the political will to cut social spending. Consequently, while Ottawa will endorse general suggestions that each Summit country live up to its international responsibility -- meaning West Germany and Japan should reflate more quickly -- it will settle for statements in the final communique that draw consensus approval. [redacted]

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International Monetary Reform

Canadian authorities believe differing national economic policies are behind the volatility of exchange rates. They believe exchange market intervention could be useful in reducing short-run fluctuations particularly if it is sizable, coordinated, and backed by appropriate domestic policies. Canada engages in official intervention almost daily to resist sharp fluctuations in its exchange rate, and Canadian officials were dismayed when they were not consulted prior to the September G-5 meeting. [redacted]

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Trade Issues

Although Canada supports liberalizing international trade by starting a new GATT round, its prime interest is in promoting freer trade with the United States -- where 75 percent of its exports now go. Canada's recent bilateral free-trade initiative is intended to secure guaranteed access to the US market, thereby eliminating what Ottawa sees as the threat of Congressional protectionism. Ottawa also expects a trade agreement to stabilize the country's investment climate. Ottawa's freer-trade plans are complicated, however, by the constitutional necessity of enlisting the support of all ten provinces. Ontario, the largest and most industrialized province, is opposed to freer bilateral trade because it fears job losses in its manufacturing industries. Consequently, Ottawa will need to expend a great deal of effort to calm provincial fears before it can establish its bargaining position for trade talks. [redacted]

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Ottawa will try to persuade other participants that its bilateral negotiations with Washington do not signal a lessening of its commitment to multilateral trade talks. Ottawa has already stressed its desire for increased trade with all Summit partners on two occasions: once in a special briefing given Europeans after Prime Minister Mulroney's initial announcement of negotiations with Washington in September, and again in a meeting between Prime Minister Mulroney and Prime Minister Nakasone at the UN General Assembly meeting in October. Nonetheless, we believe that Ottawa is convinced that the GATT process is inadequate to address Canadian trade concerns because of the country's relatively small economy, its close trade ties to the United States, and the need to blur treaty language to attain the consensus of all GATT members. For these reasons, Canada would be loath to give up bilateral talks with the United States, regardless of the views of other Summit participants. [redacted]

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Third World Debt

Ottawa generally views the recent Baker proposal favorably and is pleased that Washington is attempting to deal with the problem of inadequate lending by the commercial banks -- although Canadian officials found the proposal to be smaller and less well developed than they had hoped. Canada's summit position is likely to reflect the feeling of Canadian bankers that Brazil may be the key to debt renegotiations and may incorporate some Brazilian views. Ottawa will also argue for assistance to moderate-size debtors. This proposal was brought up by Prime Minister Mulroney in Bonn last year, and Finance Minister Wilson reiterated the need for a special mechanism for these countries in his October IMF speech. [REDACTED]

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International Terrorism

Canada has been strongly supportive of US attempts to revitalize and expand the Bonn declaration to include security and sabotage. Ottawa's interest in curbing terrorism was further galvanized by the crash of the Air India plane -- carrying more than 300 Canadians -- off the Irish coast this summer. Ottawa can thus be expected to back efforts to strengthen counter-terrorist cooperation in Tokyo. [REDACTED]

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European CommunityThe Setting

The European Community has been a back-bench participant at the annual Economic Summits since 1977, when EC Commission President Jenkins was first invited to the Summit in London. The Community's separate representation stems primarily from the demand of the smaller EC members, especially Belgium and the Netherlands, that their views on pressing economic issues be heard by the Big Seven--or, more specifically, that the four attending EC states not agree to trade or economic policies that properly should be discussed first within the EC. [REDACTED]

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The Commission President traditionally has assumed a low profile during the Economic Summits, unless given a clear mandate by the members to represent specific EC policies. However, EC Commission President Jacques Delors--the former French Finance Minister--has a more activist style than his predecessor, Gaston Thorn of Luxembourg. As a result, we expect him to speak up for the EC, as he did last year. At Bonn, Delors advocated EC cooperation in high-technology R&D as an alternative to SDI participation and criticized West Germany, Italy, and the UK for breaking the EC consensus on the the new trade round. [REDACTED]

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Together with Commission President Delors, Dutch Prime Minister Lubbers also is seeking to represent EC interests at Tokyo as the Council President. EC members agreed in 1977 that the Community should be represented at the Economic Summits by both the EC Commission President and the leader of the country holding the EC Council presidency, which rotates among EC members every six months. In 1982 the first time a non-Big Four country chaired the Council during a Summit, Belgian Prime Minister Martens was invited to represent the EC at the Versailles Summit. Diplomatic reports confirm that the Netherlands is actively lobbying for an invitation from Tokyo to next year's meeting. Even if successful, as is likely, Lubbers probably will be overshadowed by Delors. [REDACTED]

Issues of Interest

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We believe EC representatives will concentrate on three issues at Tokyo:

- o Pressuring Japan--and to a lesser extent West Germany--to stimulate their economies.
- o Insisting that Japan cut its trade surplus with the rest of the industrial world.
- o Lobbying for continued and timely joint intervention by central banks against the dollar. [REDACTED]

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We believe EC members also will support a joint statement endorsing Secretary Baker's initiative on Third World debt, but will probably prefer to minimize discussions of North-South issues to maintain maximum pressure on Japan. The Commission is likely to support discussions on structural change and cooperation on high-technology research, but almost certainly will be unable to make significant, EC-wide commitments because of continued budgetary constraints. On other Summit issues, the Commission will continue to pay lip service to combatting acid rain and to cooperation on a manned space station.

[redacted]

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Macroeconomic Policy

We believe Commission President Delors will support efforts to obtain Japanese--and to a lesser extent West German--agreement to stimulate demand in their economies. The Commission, in its annual economic report last month, determined that the EC's projected annual economic growth rate of 2 to 2.5 percent will be insufficient to reduce unemployment substantially. However, the report argues that by adopting overall monetary policies to control inflation and gearing public spending toward job creation, the EC can boost its growth rate to 3 to 3.5 percent next year. Sustaining this level of growth, according to EC forecasters, should reduce unemployment in the EC to 7 percent by 1990 from of its current record-breaking 11.2 percent.

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The Commission is calling on West Germany to lead the way toward EC-wide growth--by increasing public investment and moving scheduled tax reforms forward from 1988 to 1987--because the Commission admits that no other EC economy has the flexibility to adopt stimulative policies at this time. Positive trends are noted in Denmark, the Netherlands, the UK, and France, but none have Bonn's room to maneuver. Moreover, economic growth in Belgium, Luxembourg, Greece, Ireland, and Italy will depend primarily on the progress of their EC partners for the foreseeable future, according to the Commission. Bonn thus far has rejected in principle enacting new stimulative policies, but we believe other EC members will continue to lobby Chancellor Kohl to adopt more stimulative policies to help lead the EC out of its economic doldrums.

[redacted]

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Despite prospects for continued double-digit unemployment rates, Community funds for structural adjustment remain severely limited because of the EC's unwillingness to cut spending on its Common Agricultural Policy (CAP). CAP payments of almost \$15 billion will gobble up an estimated 70 percent of the EC's budget this year, and the 1986 budget share is likely to remain about the same. Although runaway farm spending brought the Community to the brink of insolvency last spring, CAP reform remains sidetracked. As a result, EC members are addressing structural change issues on an ad hoc basis at the national level, and EC-wide change is likely to proceed in an unbalanced and ill-coordinated fashion.

[redacted]

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International Monetary Reform

We believe the Commission will support continued joint intervention against the dollar to gradually reduce its value in foreign exchange

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[redacted]

markets. According to press reports, Commission President Delors saw the recent G-5 decision to take concerted action to lower the dollar as recognition of the link between trade, currencies, and financial policies. Moreover, we believe Delors felt personally vindicated by the G-5 decision to intervene jointly--an action Delors had advocated at the Versailles Summit in 1982 when he was the French Finance Minister. EC officials probably hope that joint intervention will strengthen the yen against West European currencies and help alleviate the EC's trade deficit with Japan while mollifying protectionist pressures in the United States. Moreover, Community members believe that joint intervention by the Big Seven may help prevent a sharp drop in the dollar which would almost certainly trigger an emergency realignment of currencies in the European Monetary System. [redacted]

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International Trade

The Commission maintains that the EC is firmly committed to promoting free trade and fighting protectionism. Nevertheless, in our judgment, the Community almost certainly will not agree to reduce significantly its own trade distorting practices. EC members recently agreed to implement a year early the tariff rollbacks scheduled for 1987 as proof of their free-trade orientation. However, the Community remains committed to protecting its farm subsidies and trade preferences that continue to fan trade tensions with the United States and other major agricultural exporters. [redacted]

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[redacted] the Commission has begun laying the groundwork for imposing significant trade measures against Japan if Tokyo equivocates at bilateral talks this month. [redacted]

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We believe the EC will soften its insistence that the new trade round be linked to international financial discussions and may agree to a late-1986 launch date. The EC's call for parallel discussions reflected concerns that international monetary issues were being swept aside by US efforts to secure an early start for the trade round. Recent US agreement to intervene jointly against the dollar and Secretary Baker's initiative on Third World debt appear to have allayed these fears. More important, in our judgment, is their hope that an early start to negotiations will ease increasing trade tensions with the United States. Nevertheless, the EC will continue to argue that LDC concerns over the new round's agenda--especially services--should be accommodated if possible. [redacted]

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High Technology

Commission President Delors is likely to endorse wholeheartedly further cooperation in high-technology research at Tokyo, but we believe the EC's role in this area has been overshadowed by EUREKA--the French initiative to create a separate framework for West European high-tech cooperation. EUREKA has not replaced or superseded existing EC high-tech initiatives, but it has drawn

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attention--and perhaps funding--away from EC research programs. The EC Commission probably will be permitted to participate in EUREKA's planning and contribute to a small secretariat. Funding and project selection, however, will remain the prerogative of the participating West European governments, and Delors probably will have no authority to speak on their behalf.

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